

ANSWERS TO QUESTIONS - CHAPTER 1

- 1. Stakeholders are the parties that use accounting information.**

Stakeholders with a direct interest include owners, managers, creditors, suppliers, and employees. These individuals are directly affected by what happens to the business.

Stakeholders with an indirect interest include financial analysts, brokers, attorneys, government regulators, and news reporters. These individuals use information in the financial reports to advise and influence their clients.

Students may give many different answers under the above categories depending on their level of experience in business.

All students are direct users of accounting information related to tuition and fees, financial aid, and account balances.

- 2. Accounting provides information that is useful in making decisions by all participants in the market for resource goods and services, both profit-oriented and nonprofit oriented. Because accounting's role is so important, it is often called the language of business.**
- 3. The primary mechanism used to allocate resources in the U.S. is competition for resources in the open market.**
- 4. A market is a group of people or organizations that come together for the purpose of exchanging items of value.**
- 5. The market for business resources involves three distinct participants: consumers, conversion agents, and resource owners. See Exhibit 1-1 that illustrates how market trilogy is involved in resource allocation.**

6. Financial Resource: money

Physical Resource: natural resources (i.e. land, forests, mine ore, petroleum, etc.), buildings, machinery and equipment, furniture and fixtures

Labor Resource: includes both intellectual and physical labor; i.e. employees

7. Investors expect a distribution of the business's profits as a return on their financial investment (capital allocation).

Creditors lend financial resources to businesses and receive interest as a return or profit on the loan.

8. Financial accounting provides information that is useful to external resource providers.

Managerial accounting provides information that is useful to managers in operating an organization (i.e., internal users).

9. Not-for-profit or nonprofit entities provide goods or services to consumers for humanitarian or special reasons rather than to earn a profit for owners. For example, certain not-for-profit entities allocate resources to provide for research of diseases or social/environmental welfare; others allocate resources to promote the arts and provide education.

10. The U.S. rules of accounting information measurement are called generally accepted accounting principles (GAAP).

11. Careers in public accounting consist of providing services to the general public from a public accounting firm. These services include auditing, tax, and consulting services. Careers in private accounting usually consist of working for a specific company (which would be a client of the public accounting firm) providing a wide variety of services to the company including recording transactions, preparing financial statements, internal auditing, and others.

12. Items reported on the financial statements are organized into classes or categories called elements. The ten elements of financial statements are:

- 1. Assets**
- 2. Liabilities**
- 3. Equity (Stockholders' Equity)**
- 4. Investments by Owners (Contributed Capital)**
- 5. Revenue**
- 6. Expenses**
- 7. Distributions (Dividends)**
- 8. Net Income**
- 9. Gains**
- 10. Losses**

Accounts are specific items or subclassifications of the elements. Examples of accounts include cash, land, and common stock.

- 13. Assets, the economic resources of a business, are used to produce earnings.**
- 14. The assets of a business belong to that business entity and there may be claims on the assets. Claims on the assets belong to resource providers.**
- 15. Creditors are individuals and/or institutions that have provided goods or services to the business which are not yet paid for, or loaned money to the business. These parties have first claim to the assets of the business, and the investors have a residual interest in the assets.**

16. The term “liabilities” is used to describe creditors' claims on the assets of a business.

17. The accounting equation is:

$$\begin{aligned} \text{ASSETS} - \text{LIABILITIES} &= \text{STOCKHOLDERS' EQUITY} \\ \text{or} \\ \text{ASSETS} &= \text{LIABILITIES} + \text{STOCKHOLDERS' EQUITY} \end{aligned}$$

Assets are the economic resources used by a business for the production of revenue. Liabilities are obligations of a business to relinquish assets, provide services, or accept other obligations. Equity, also called “residual interest” or “net assets”, is the portion of the assets remaining after the creditors' claims have been satisfied (i.e., Assets – Liabilities).

18. The owners ultimately bear the risk and collect the rewards associated with operating a business.

19. A double-entry bookkeeping system is one in which every transaction affects at least two accounts. A transaction can affect both assets and claims (liabilities and equity) or only assets or only claims. In order to “balance” the accounting equation, every transaction requires a “double entry.”

20. The right side of the accounting equation can be viewed as either sources of assets or as obligations and commitments of the business. Assets originating from liabilities can be viewed as sources or obligations of the business. Assets originating from issuing stock or retaining earnings can be viewed as sources of assets and commitments of the business.

21. The business could make a distribution of \$1,000, but only \$800 of it would be classified as a dividend. A distribution can only be a dividend to the extent of retained earnings.

22. Capital is acquired from owners by issuing stock to them. When stock is issued, the assets of the business increase and the stockholders' equity increases.

- 23. Assets that are acquired by issuing common stock are the result of investments by owners. Assets that are acquired by using retained earnings are assets the business acquires through its earnings activities.**
- 24. Revenue increases the asset side of the accounting equation and also increases the retained earnings account in the stockholders' equity section of the equation.**
- 25. The three primary sources of assets are (1) investments by owners (issue of stock), (2) borrowing from creditors, and (3) earnings activities.**
- 26. Retained earnings are a result of a business retaining its earned assets, rather than distributing those earnings to its owners.**
- 27. Distributions to owners, called dividends, decrease the asset side of the accounting equation and also decrease the retained earnings account in the stockholders' equity section of the equation.**
- 28. Dividends and expenses are similar in that they both decrease assets and affect the accounting equation in the same way (i.e. reduction of retained earnings). However, dividends differ from expenses because of the nature of the decline in assets. Expenses reduce assets as the result of a firm's efforts to earn revenue. Dividends reduce assets because of a transfer of wealth to the owners.**

29. (1) **Income Statement** - measures the difference between the asset increases and the asset decreases that were associated with operating a business during a particular accounting period.
- (2) **Statement of Changes in Stockholders' Equity** - explains the effects of transactions on stockholders' equity during the accounting period.
- (3) **Balance Sheet** - lists the assets and the corresponding claims against the entity as of a particular date.
- (4) **Statement of Cash Flows** - explains how a company obtained and used cash during the accounting period.
30. The **Balance sheet** provides information about the enterprise at a particular point in time.
31. A net loss occurs when expenses exceed revenues in a given accounting period.
32. A business liquidation is when a business ceases to operate, its remaining assets are sold and the sale proceeds are returned to creditors and owners.
33. The going concern doctrine assumes that a business is able to continue its operations into the foreseeable future.
34. The matching concept is the practice of pairing revenues and expenses on the income statement.
35. (1) **Operating activities** - explain the cash generated from revenue and the cash paid for expenses.
- (2) **Investing activities** - include cash received or spent by the business on productive assets used in the business, and investments in debt or equity of other companies.
- (3) **Financing activities** - include cash inflows and outflows from the company's transactions with its owners and inflows and outflows from its borrowing activities.
36. Asset accounts are arranged on the balance sheet in accordance with their level of **liquidity** (those that can be most quickly converted to cash are listed first).

- 37. Articulation refers to the interrelationships among the various elements of the financial statements.**
- 38. Temporary accounts are used to capture information for a single accounting period. The balances in temporary accounts are transferred out of the accounts at the end of the accounting period. Temporary accounts have zero balances at the beginning of an accounting period. Temporary accounts include revenue accounts, expense accounts, and dividends. Permanent accounts carry over from one accounting period to the next. Retained Earnings is a permanent account.**
- 39. The information in the temporary accounts is transferred to Retained Earnings at the end of the accounting period so that the temporary accounts have a zero balance at the beginning of the next accounting period. This allows the income statement and statement of cash flow information to be presented for a certain period of time. Since information from last period has been transferred, only the information that pertains to the current accounting period is contained in the accounts.**
- 40. The historical cost concept requires that most assets be reported at the amount paid for them regardless of their increase or decrease in value. It is related to the qualitative characteristic of verifiability in that information can be independently verified. The historical cost is verified, while a change in value is subjective.**

41. An asset source transaction results in an increase in an asset account and an increase in one of the claims accounts; i.e., investments by owners (equity), borrowing funds from creditors (liabilities), or earnings activities (revenue).

An asset use transaction results in a decrease in an asset account and a decrease in either liabilities or equity; i.e., the payment of a liability, the payment of an expense, or a dividend.

An asset exchange transaction is a transaction in which one asset is exchanged for another; i.e., purchase of land with cash.

A claims exchange transaction will be covered in a later chapter.

42. While the contents of annual reports vary from company to company, all annual reports contain:
Management's discussion and analysis (MD&A)
Financial statements
Notes to the financial statements
Auditor's report
43. U.S. GAAP, generally accepted accounting principles in the United States, are the measurement rules established by the (FASB) Financial Accounting Standards Board. The FASB is a privately funded organization with the primary authority for establishing accounting standards in the United States. International Financial Reporting Standards (IFRS) are issued by the International Accounting Standards Board and are an attempt to set a common standard to be used in different countries. IFRS is used by global companies and there is a move underway to merge GAAP and IFRS or to lessen the differences between them.

Event Number	Balance Sheet					Income Statement			
	Assets		=	Liabilities	Equity		Revenue	- Expense	=
	Cash	Land		Loan	Contributed	Retained			
				Payable	Capital	Earnings			
1	\$6,100				\$6,100				
2									
3									
4									
5									
6									
Totals	\$6,100	\$0		\$0	\$6,100	\$0	\$0	\$0	
		\$6,100		\$6,100					
		Total Assets		Total Claims					

<u>it</u>	Statement of	
	Cash Flows	
<u>Net</u>	<u>Amount</u>	<u>Activity</u>
<u>Income</u>		
	\$6,100	Financing

\$0	\$6,100

ACT1-9 Answer Key

Event Number	Balance Sheet					Income Statement			Statement of Cash Flows		
	Assets		=	Liabilities	Stockholders' Equity		Revenue - Expense	=	Net Income		
	Cash	Land		Loan	Common Stock	Retained Earnings					
				Payable							
1	\$6,100				\$6,100				\$0	\$6,100	FA
2	(4,400)	4,400							0	(4,400)	IA
3	3,000			3,000					0	3,000	FA
4	700					700	700		700	700	OA
5	(300)					(300)		300	(300)	(300)	OA
6	(100)					(100)			0	(100)	FA
Totals	\$5,000	\$4,400		\$3,000	\$6,100	\$300	\$700	\$300	\$400	\$5,000	
		9,400		9,400							
		Total Assets		Total Claims							